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THE WISCONSIN INCOME TAX

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During the last half century the trend of opinion on the subject of taxation has strongly set in the direction of the faculty tax or contribution to the support of government in proportion to ability to pay. In theory at least this principle of taxation is both attractive and convincing and it has received the endorsement of publicists, economists and students of taxation generally. Under normal conditions all taxes are paid out of income and a system, which exacts payment from those who have the means to pay, relieves those who have not, taxes moderate income lightly and large income more heavily, makes strong appeal for popular favor and has much to commend it on the economic side. For nearly a hundred years the income tax principle has been utilized in European countries and in one form or another now constitutes an important element in the fiscal system of every advanced country in Europe except France. Its highest development is found in England and Germany, where the annual yield aggregates over \$200,000,000 in each country.

Prior to 1913, the income tax had never been generally adopted in this country. It was resorted to by several of the colonies prior to the adoption of the constitution, but not in its modern form. The Civil War income tax contributed \$372,000,000 to the general government from its adoption in 1862 until its repeal ten years later. A general income tax act was enacted by Congress in 1894, which the supreme court held to be in conflict with the federal constitution as it then stood. The adoption of the sixteenth amendment expressly authorizing the raising of revenue by this means, followed by the federal act of 1913, is therefore the first step toward a permanent adoption of income taxation in this country.

In the meantime about twenty states had experimented with an income tax in one form or another. Several of the Atlantic and Southern states adopted this means of raising revenue about the middle of the last century and extensive use was made of the system by the states of the Confederacy during the civil war period. Few,

if any, of these enactments, however, provided for the taxation of all forms of income. As a rule they were confined to the taxation of income derived from sources not otherwise taxed, such as salaries, fees, commissions and profits derived from the purchase and sale of property.

The difficulty of allocating income derived from interstate commerce and the uncertainty as to whether any part of such income could be taxed by the individual states, operated against the general adoption of the system. Moreover, the states which did adopt an income tax committed the administration to local taxing officers, and the result was a lax enforcement and very meager yield. These unsatisfactory results led to a widespread feeling that income taxation was not practicable for the separate states and prevented the adoption of the system for many years.

In the meantime the subject of taxation was becoming more and more important. With the increase in urban population and the growing complexity of social and business conditions, taxes naturally increased. It was found that the property tax system, however well suited to primitive condition and agricultura communities, no longer sufficed. It abounded in inequality and discrimination in the assessment of all classes of property and failed outright as to some. While the tax upon real estate absorbed from 10 to 20 per cent of the income therefrom, the property tax afforded no means of reaching excess earnings, or to secure any contribution from income derived from other than property sources. Wisconsin in common with many other states shared this experience. While it was estimated that the value of personal property in the state was equal to that of real estate, only about 18 per cent of the public revenue was derived from that source, and no serious attempt was made to reach intangible property at all. In 1909 six of the seventy-one counties of the state made no assessment of moneys and credits. A substitute for the broken down personal property tax was therefore eagerly sought for and students of the subject naturally turned to the income tax as the solution.

In 1908 an amendment to the constitution was adopted authorizing the taxation of incomes at graduated and progressive rates. The legislature of 1909 appointed an interim committee to study the subject and report to the legislature of 1911, and the present income tax law is the result. The act provided for the assessment o all in-

comes received during the year 1911, and the first assessment was made in 1912. We are now closing our third assessment under the law.

Under the federal constitution and decisions the legislature had the option to tax all income received by residents of Wisconsin, and all income received by non-residents from property located or business transacted in this state. Obviously the adoption of this program would involve certain inconsistencies. If residents of Wisconsin were to be taxed upon income from property located and business transacted without the state, consistency would require that income received by non-residents from property located and business transacted in Wisconsin should be exempt. If adjoining states should adopt a similar system, residents of this state deriving income from business and property in these states would be subject to a double tax. To avoid these difficulties the legislature finally decided to limit the tax to income derived from persons, property and business having an actual or constructive situs in this state. Accordingly residents of Wisconsin are taxable on all compensation for personal services received by them, whether in the form of salaries, commissions or other earnings, and upon all dividends from corporate stocks and interest on securities owned by them, regardless of the place of investment. The legal situs of such property and the income therefrom follow the residence of the owner or recipient. On the other hand income from fixed property, such as royalties or rents and profits from definitely localized business, is assigned to the district in which such property is located or business transacted. It follows that income of this latter character derived from property located or business transacted without the state is not subject to the Wisconsin tax.

Substantially all forms of income flowing from these sources are subject to the tax. Public service companies, such as steam and street railways, telephone and telegraph companies, which are assessed by the tax commission and pay taxes directly into the state treasury, are exempt for the reason that the element of earnings is taken into account in the assessment of these companies under the property tax. Moreover, the property of these companies is declared to be personalty for the purpose of taxation and if assessed they would be permitted to offset their property tax against the income tax levied against them under a provision of the statute hereinafter.

explained. The usual exemptions are extended to religious, charitable and educational institutions.

The basis of the tax is net income, ascertained by deducting from the gross income of the taxpayer for the year covered by the return the ordinary expenses incurred in producing it. This includes the cost of labor, material and goods, taxes, insurance, interest, depreciation and repairs. The rate is progressive in each case, beginning at 1 per cent on the first \$1,000 of taxable income in the case of individuals and progressing by easy stages of one-quarter of 1 per cent per \$1,000 up to \$5,000, and one-half of 1 per cent on each additional \$1,000 until the maximum 6 per cent rate is reached. All income above \$11,000 in the case of individuals, and above \$6,000 in the case of corporations is taxed at the uniform rate of 6 per cent. The corporation rate is double the rate of individuals until the maximum is reached. Under this method a taxpayer of moderate means with a taxable income of \$1,000 is required to pay a tax of only ten dollars, while his more prosperous neighbor receiving an income of \$10,000 pays not merely ten times as much or \$100, but twenty-five times as much or \$250. In like manner a corporation having a taxable income of \$1,000 is required to pay only twenty dollars tax, whereas its larger and more prosperous rival, with a taxable income of \$50,000, is required to pay not fifty times as much, or \$1,000 but one hundred and forty-two times as much, or \$2,840. The widow's mite still involves more sacrifice than the rich man's largess for "he pays out of his abundance but she out of her want."

As corporations pay the tax on their entire net income, provision is made for deducting the dividends received therefrom to avoid double taxation. The same is true of profits received from a partnership whose income has been assessed or is taxable under the law. The tax is computed on the entire net income before distributing it in the form of dividends or profits. Approximately two-thirds of the total tax levied under the Wisconsin law is derived from corporations, and one-twentieth from partnerships, indicating the extent to which it is possible to collect at the source. Another and very effective provision of the law is that of requiring corporations to report the names of employees who are paid a compensation exceeding \$700 per year as a condition of deducting that item of expense. Similar provision is made in the case of payment of interest, dividends and rent. These lists of payments are reported to the tax commission

in connection with the return of the corporate income and are then distributed to district assessors as a check against the returns made to them by the individuals receiving the payments. This provision is believed to be less complicated and quite as effective as the method of withholding the tax prescribed by the federal income tax act.

An exemption of \$800 is allowed individuals without family; \$1,200 for husband and wife; and \$200 additional for each child under eighteen years of age or other person dependent on the taxpayer for support. An ordinary family of five has therefore an exemption of \$1,800. Compared with the average income of the wage-earning class, these exemptions amply cover the cost of subsistence and are much more liberal than the exemptions allowed in European countries. Considering that all expenses of producing the income are deducted before the exemptions are taken out, it is plain that no poor person is required to pay an income tax under the Wisconsin law. An individual or family receiving a net income exceeding these exemptions is not poor in either the popular or economic sense. Only two per cent of the total population, or about one family in ten, is subject to the tax. As corporations have no physical needs and are not subject to the infirmities of natural persons, no exemptions are allowed to them. Moreover, in arriving at the taxable income of corporations the salaries of officers, as well as the wages of employees, are deducted. Their taxable income therefore represents profits from business and property only, exclusive of personal earnings, whereas natural persons are required to include income from personal earnings in their reports.

The tax is primarily for the support of local government. Seventy per cent of the proceeds is paid to the town, city or village in which the income is produced, 20 per cent to the county comprising the district, and 10 per cent to the state. It is not therefore an additional tax but merely another means of raising needed revenue for the support of local government. In preparing their annual budgets local officers are required by law to take into account the revenues available from other sources than the property tax, including the amount of income tax levied in and for each district. To the extent that a given community is required to pay an income tax therefore, it is relieved from the payment of a property tax. Bearing in mind that at least one-half of the income tax levied is derived from sources which escaped altogether under the property tax, it is clear that it

does not operate as an additional burden. Incidentally we may add that the 10 per cent of the net proceeds of the income tax payable to the state, after allowing the personal property offset, not only covers the cost of administration but defrays the entire expense of all the activities of the tax commission, including the salaries and expenses of assessors of incomes. The average cost of the Wisconsin income tax is about 1.2 per cent of the amount assessed, making it one of the cheapest taxes known.

Perhaps the most distinctive feature of the Wisconsin law is its centralized administration. The state tax commission is required to assess the incomes of all corporations and to prescribe rules and forms for the assessment of the incomes of individuals and partnerships. The commission is authorized to divide the state into assessment districts and to appoint subordinates to assess the incomes of individuals and partnerships in their respective districts. The state has been divided into forty-one districts and an assessor of incomes appointed for each district at a salary fixed by the commission. These appointments are made under civil service rules, for a term of three years, and the assessors work under the direction of the commission and are subject to removal from office for adequate cause. They are wholly free from local or partisan influence and have proved a very efficient force.

The agitation for an income tax in Wisconsin grew out of dissatisfaction with the personal property tax which it was originally designed to replace. Accordingly substantial exemptions of personal property were made by the law which created the income tax. All moneys and credits, household furniture, farm machinery and numerous minor classes of personal property were exempted by that act. As the law was untried and its validity certain to be questioned in court, it was deemed prudent to retain the tax on tangible personal property until the effectiveness of the income tax could be more fully tested. Provision was accordingly made for the deduction of personal property tax paid by any person for a given year from the income tax levied against him for the same year. Owners of taxable personal property, therefore, pay no income tax unless it exceeds the amount of their personal property taxes.

The first assessment under the income tax law for the entire state resulted in a tax of \$3,501,000, and the second assessment in a tax of \$4,094,000. The assessment for the current year just com-

pleted shows a tax of \$4,140,000. These figures fairly represent the revenue producing power of the income tax, but the net yield is materially reduced by the offset provision referred to. Approximately one-half of the amount of income tax assessed is subject to offset by the personal property tax. The net yield of the 1913 income tax based on 1912 income, excluding disputed items in litigation, was \$1,935,846, and the same proportion of the assessment of the current year is likely to be wiped out by the personal property offset. As the tax on personal property is required to be paid in full in any event, and only the difference between that amount and the income tax is collected, the net proceeds mentioned fairly represent the amount of revenue derived under the Wisconsin law from sources not reached by the property tax at all.

The conventional criticism of a state income tax has long been that it is all right in theory but will not work in practice. The experience of all the states which experimented with the system prior to 1911 could well be cited to sustain this claim. Obviously if the criticism is well founded it constitutes a fatal objection to a state income tax. In last analysis, a fiscal system must be tested by results. The important question, therefore, is, how has the Wisconsin income tax law actually operated in practice? The first and most obvious test of a tax system is its power to produce revenue and, as already shown, the Wisconsin law has fairly met this test. The average annual assessment for the three years during which it has been in operation is approximately \$4,000,000. The total yield of the Civil War income tax during the first year of its operation was less than \$3,000,000. The highest tax ever collected in any other state in a single year under an income tax was less than \$200,000. The income tax assessed in the county of Milwaukee alone in 1913 was \$1,825,024. Compared with the results of other state income taxes, the Wisconsin law is facile princeps as a revenue producer.

Experience thus far has shown that the principal yield of the income tax comes from the centers of business and population. It is therefore primarily an urban tax. Milwaukee city alone contributes over 40 per cent of the taxable income assessed, and fifteen counties containing the principal cities furnish 75 per cent of the total for the state. Less than one-half of one per cent of the population in strictly rural districts is subject to the tax, and the yield is comparatively insignificant. The limited cash profits from agriculture,

and the large exemptions, practically exclude farmers from the operation of the law. In several rural districts the yield is not sufficient to make up for the personal tax on moneys and credits and other property exempted by the act. Inasmuch, however, as the revenue derived is mainly distributed to the districts which produced the income no serious injustice results. To the district which has of income is given of taxes. An amendment to the law increasing the proportion distributed to state and county would tend to correct this defect.

The income tax is also primarily a tax upon the rich and well-to-do. Analysis of the assessments of a selected group of 382 persons subject to the tax in the city of Milwaukee for the year 1912 showed an aggregate income tax of \$176,808. Of this number, 88 persons, whose taxable incomes were less than \$1,000 each, paid only \$487 aggregate tax. One hundred thirty-nine (139) persons belonging to the group, whose taxable incomes exceeded \$10,000, paid \$168,822 income tax, or 95 per cent of the total. The total income tax assessed against 3,172 individuals in Dane County for the current year is \$67,050. Of the number assessed 2,150 had a taxable income of less than \$1,000 each, and their aggregate tax was only \$8,496.80, or about one-eighth of the total, whereas six persons, having an income of over \$15,000 each, will pay \$23,202 income tax, or more than one-third of the total tax assessed. In the city of Sheboygan five of the 1,272 persons assessed pay more than one-fifth of the total tax.

A comparison of the personal property tax with the income tax according to the amount of income shows that the average person whose income is less than \$1,000 has four dollars more personal property tax than income tax whereas those having a taxable income between \$5,000 and \$10,000 pay an average of twenty-two dollars more income tax than personal property tax. More striking still, the average taxpayer having an income in excess of \$10,000 in the selected group first mentioned pays \$659 more income tax than personal property tax.

An analysis of assessments by occupation yields equally interesting results. Twenty-five lawyers included in the selected group paid a personal property tax of \$4,237 in 1911 as against an income tax of \$12,360 for 1912. Twenty-one other professional men who were assessed for \$9,137 income tax paid a personal property tax of

\$811. Forty brokers, salesmen and solicitors paid an income tax of \$13,974 in 1912 as against a property tax of \$1,803 in 1911. Seventeen capitalists, whose personal property tax was \$1,448, paid an income tax of \$13,233 in 1912. These figures clearly show the unequal operation of the personal property tax and the greater efficiency of the income tax in securing revenue from those who are best able to bear the burden. Obviously, measured by ability to pay, the person having a small taxable income was overcharged under the personal property tax, and the person having a large income did not contribute his share.

Perhaps the most important result of the income tax law in this state is its effect upon the administration of the property tax. As predicted by Professor Adams before the law was enacted its by-products are more valuable than its direct results. The assessors of incomes above referred to supervise the administration of the property tax and their services in that respect have been no less important than in assessing incomes. Selected by a merit test, free from local influence, constantly employed and therefore becoming increasingly efficient, they have made marked improvement in the administration of the property tax. While increased valuation does not necessarily mean good assessment, it strongly points in that direction. After ten years of effort on the part of the tax commission to secure some approach to a legal assessment of property, the average ratio of assessed to true value was less than 65 per cent. The first year's experience under assessors of incomes increased this ratio to 73 per cent, and the second year to 81½ per cent. Complete returns have not yet been received from all districts of the state for the current year, but reports from assessors of incomes indicate that many districts have been assessed on a substantially full value basis, and that the average ratio of assessed to true value for the state will not fall materially short of 85 per cent. This result may be ascribed in large measure to the income tax law with its accompanying exemption of moneys and credits and the provisions for the appointment of assessors of incomes.

It is often urged that the income tax is inquisitorial, but so is every tax when properly administered. Under the property tax law the assessor may examine the taxpayer and call his neighbors to testify as to the amount and value of his property. He may even disregard the taxpayer's sworn statement and increase the assessment

according to his own judgment. Every community will continue to raise revenue by taxation in one form or another, and as the burden increases will insist upon the necessary information to measure the amount. Concealment and evasion will not permanently avail. The choice, therefore, lies between a system which reaches all sources of revenue, automatically adapts itself to changing conditions, takes note of the productiveness of different classes of property and graduates the burden accordingly, and a partial, rigid, mechanical system with a long train of failure and injustice in its wake.

Objection is often made that no state can tax income derived from interstate commerce, and numerous expressions are found in the books to that effect. But the courts have repeatedly held that any state may tax property engaged in interstate commerce if a reasonable basis of apportionment be used to determine the proper proportion assignable to that state. Why should not the same rule be adopted in the case of income derived from interstate commerce? If Wisconsin cannot tax income from this source no other state can do so, and the result is a legal no-man's-land where vast and prosperous organizations may operate, relieved from the burdens which others are compelled to bear. All agree that neither property nor income from interstate commerce should be singled out for invidious discrimination, but that is a very different thing from requiring it to bear its just share of the public burden. If there is any doubt or uncertainty in the law in this respect, why should not Congress, which has supreme control of the subject, authorize the several states to tax either property or income from interstate commerce according to any system of taxation applicable to other property and business within their borders, under reasonable rules of apportionment. It has already made such provision in the case of national banks. Such a declaration on the part of Congress would solve many difficulties and remove many doubts. With this obstacle out of the way, it is believed that income taxation may be resorted to by any state with advantage to its own revenue and greater equality in the distribution of public burdens among its citizens.